INTRODUCTION

Earlier this year, Godwins submitted a report to the United States Telephone Association (USTA) analyzing the impact of SFAS 106 on the GNP-PI, and, in particular, the extent to which the GNP-PI will reflect the increase in costs experienced by the Price Cap LECs as a result of adopting the new accounting standard. This report was placed on the record with the FCC in Bell Atlantic's Tariff Transmittal filed on February 28, 1992 (Transmittal No. 497) and was also included in U.S.West's Tariff Transmittal filed on April 3, 1992 (Transmittal No. 246).

In their filings with the FCC, several organizations took exception to the findings of that report. In particular, AT&T, MCI and the Ad Hoc Telecommunications Users Committee raised several objections with regard to various aspects of the study. The USTA has asked Godwins to provide a detailed response to each of those objections.

The purpose of this Supplemental Report is to provide the USTA with those responses. We have organized our responses into three sections, corresponding to the three different types of objections raised.

While the objections raised were numerous, this material will demonstrate that none of the objections raised should cause the Commission to have any doubts regarding the soundness of the study, or the validity of the results.

Respectfully Submitted,

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SECTION I

RESPONSE TO OBJECTIONS REGARDING OVERALL STUDY

A. Definition of Double Count

There were two objections raised with respect to the manner in which we defined the potential sources of double counting and what sort of analysis would be required to eliminate any double counting in determining the portion of the LECs' SFAS 106 costs that should qualify for exogenous treatment.

AT&T Contention - (Pages 6 and 7) "The LEC's have failed to demonstrate that the Commission's third criteria is met. To the contrary, the LECs' requests for exogenous treatment appear to reflect certain OPEB costs that will be reflected in the GNP-PI ... The double count occurs because (i) the GNP-PI component of the PCI will increase as all firms with OPEB liabilities reflect those costs through higher prices, and (ii) the SFAS 106 accrual calculation includes the present value of future inflation. If the SFAS 106 accrual is afforded exogenous treatment, the amount of the accrual will be increased automatically in future periods due to growth in inflation expressed by the GNP-PI component of PCI.** Therefore, if inflation is included in both the exogenous cost component and GNP-PI, an LEC would be compensated twice. Although the LECs recognize this problem, no carrier has met its burden of showing that it has effectively removed this double count."

Response - AT&T's description of what it considers the source of potential double counting in the LECs' request for exogenous treatment for increased costs due to SFAS 106 demonstrates some confusion as to both the double count problem and the Godwins Report. Essentially AT&T suggests that double counting may arise from two separate sources:

(1) Increases in the PCI due to increases in the GNP-PI caused by "firms with OPEB liabilities reflect(ing) those costs through higher prices."

(2) Automatic increases in the exogenously treated portion of SFAS 106 accrual "due to growth in inflation expressed by the GNP-PI component of PCI."

The first source of potential double count, while a valid concern, is precisely the factor that the Godwins Report directly and thoroughly addresses. The first paragraph of page 1 of the Godwins Report explicitly states this as the primary objective of the study. As will be seen in the responses to specific criticisms of the Godwins Report, no respondent has raised any issue which, upon scrutiny, casts doubt on any of the basic findings of the study. Therefore, the Commission should accept the Report's conclusions that (a) this source of double count accounts for 0.7% of the increase in costs attributable to SFAS 106, (b) another 14.5% of the increase will be recovered through a reduction in the national wage rate, and (c) the remaining 84.8% of such increase in costs will remain unrecovered unless exogenous treatment is granted on this amount.

The second alleged source of double counting simply doesn't exist, and is the result of confusion over exactly what the LECs are requesting. While it is true that the SFAS 106 expense calculation includes the present value of future inflation, and that the expense calculated under SFAS 106 can be expected to increase each year at something close to the rate of inflation, SFAS 106 expense is not what the LECs are requesting exogenous treatment on. It is the increase in expense due to the SFAS 106 accounting change that should be afforded exogenous treatment. This is an absolutely critical distinction which is missed by AT&T. Retiree medical plans were sponsored by firms before and after SFAS 106 was issued. It is only the accounting for those plans that has changed, and it is the increase in costs associated with this change in accounting that must be evaluated.

MCI Contention - (Page 30)

"If one were to include SFAS 106 costs through exogenous treatment, the revenues resulting from the increase in the price cap index to account for these costs would also increase each year by the GNP-PI, as adjusted for the productivity factor. The problem is that SFAS 106 costs have already been adjusted for future inflation...Therefore, the impact of medical care cost inflation has already been counted. As such the amount offered by the LEC's has been inflated to reflect future medical costs. To include these costs again within the price cap formula through exogenous treatment, and treat them by the full amount of GNP-PI which has medical inflation embedded as well is tantamount to double counting the medical care inflation rate."

Response -

This contention is virtually identical to the second "source" of double counting outlined by AT&T on page 7 of its filing with the Commission. Rather than repeat our response to that contention, we would just point out that, like AT&T, MCI seems to have failed to grasp the point that the LECs are not asking for exogenous treatment on the SFAS 106 expense, rather they are asking for exogenous treatment on that portion of the increase in expense due to the mandated accounting change, which will not already be reflected in GNP-PI increases caused by that accounting change.

B. Avoidance of Double Count

Two respondents suggested "better" ways of determining the extent of the double count problem, and therefore "better" ways of determining the appropriate portion of SFAS 106 costs that should qualify for exogenous treatment.

AT&T Contention - (pp. 13 - 14)

"....The Commission should require the LEC's to use an alternative that is both a simpler and more reliable means for correcting the double count. AT&T suggests that the appropriate method for removing the double count between the SFAS 106 accrual and the GNP-PI term in the price cap formula is to remove the impact of expected changes in GNP-PI from the SFAS 106 accrual. This can be accomplished in a straightforward manner by requiring the LEC's to subtract the expected rate of change of GNP-PI from the health care inflation component in the SFAS 106 accrual. The Commission should specify the changes in GNP-PI over the SFAS 106 forecast period. Current estimates is (sic) that GNP-PI will increase approximately 4% over the long term."

Response -

That AT&T should suggest such an illogical and erroneous "solution" to the double count problem is indicative of a failure to understand the true source of any potential double counting. As discussed earlier, potential double counting is not related to the fact that SFAS 106 costs are calculated by discounting future medical inflation back to the present. As discussed on page 2 of this material, double counting will only arise to the extent that the increased costs companies will bear, as a result of the change in accounting method required by SFAS 106, will also cause an increase in GNP-PI.

The fact that the AT&T "solution" does not address the true source of potential double counting is illustrated in the following example, where the AT&T solution is shown to produce an identical exogenous adjustment in two factually different circumstances, where logic would dictate different exogenous adjustments be applied.

In the second footnote on page 13 of its filing, AT&T estimates that its "solution" of allowing exogenous treatment for SFAS 106 accruals, calculated using a medical trend rate 4% lower than the actual rate used by the LECs for their financial statements, might result in approximately 55% of a given LEC's actual SFAS 106 accrual being afforded exogenous treatment. Now let us consider two hypothetical scenarios:

(1) Every U.S. firm, LECs and non-LECs alike, have identical demographic makeups and provide identical retiree medical benefits. Thus, in this case, presumably every U.S. firm would experience the same increase in labor costs due to SFAS 106. In addition, under this scenario, it is assumed that all labor cost increases associated with SFAS 106 are completely reflected in the GNP-PI, as companies raise their prices to recover those costs.

(2) The LECs are the <u>only</u> firms subject to SFAS 106, and/or the additional costs due to the adoption of SFAS 106 costs are never reflected in the GNP-PI.

In the first scenario, it is obvious that the increased labor costs due to SFAS 106 experienced by the LECs would be fully and completely reflected in the GNP-PI (the Godwins Report, of course, demonstrates that this hypothetical situation does not exist), and thus no exogenous adjustment would be required. In fact, in this hypothetical scenario, providing any exogenous adjustment would result in a complete double count. Yet in this circumstance, the AT&T approach of allowing recovery of SFAS 106 costs, calculated using a lower trend rate (medical inflation minus 4%), would, as noted above, result in allowing exogenous treatment on 55% of SFAS 106 accruals.

Conversely, under the second scenario, the LECs should receive an exogenous adjustment equal to 100% of their increased costs due to SFAS 106, because the double count problem simply wouldn't exist. Yet in this circumstance as well, the AT&T approach would allow an exogenous adjustment for the same 55% of SFAS 106 accruals as before. This is clearly an illogical result.

One can therefore see that AT&T's suggested approach to the double count does not address the specific factors that affect the extent of double count, i.e.:

- Differences in plans between the LECs and non-LECs

- Differences between the LECs and non-LECs which will give rise to different SFAS 106 costs (e.g., demographic differences).

- Proportion of increased aggregate labor costs due to SFAS 106, that in fact is reflected in GNP-PI.

As noted, it is precisely these critical factors detailed above that are addressed completely and comprehensively in the Godwins Report.

<u>MCI Contention</u> - (Page 31)

"If the Commission does decide to afford these LECs exogenous treatment for SFAS 106 costs, this double counting must be eliminated. This can be accomplished either through the removal of medical care inflation from the GNP-PI or through the removal of medical care inflation from the SFAS 106 accruals."

<u>Response</u> -

While this "solution" differs slightly from AT&T's suggested "solution" (pages 13-14 of its filing) in that MCI focuses on the medical care inflation component of GNP-PI, conceptually it is very similar, and suffers from the same fundamental flaws as the AT&T suggestion. As with AT&T, the MCI suggestion simply doesn't address the source of any potential double count. The double count does not arise from the discount of future inflation, but only from the differential impact of SFAS 106 on the LECs relative to others, and the extent to which the price cap index will allow the LECs to recover some of those additional costs, as the macroeconomic effects of the introduction of SFAS 106 are reflected in the economy as a whole. As with the AT&T solution, the MCI solution produces the same exogenous adjustment, whether in reality there is no double counting (no non-LEC firm incurs SFAS 106 costs), or complete double counting (all firms, including LECs, experience identical increases in costs due to SFAS 106, and the GNP-PI fully reflects those increased costs). This is clearly an illogical result.

SECTION II

RESPONSE TO OBJECTIONS REGARDING ACTUARIAL ANALYSIS

A. Methodology

There were three objections raised with respect to the basic methodology employed in the actuarial analysis undertaken by Godwins.

AT&T Contention - (pp. 11 -12)

"... the study is flawed because the government sector is not included. Although SFAS 106 does not affect the accounting practices of the government, growth in retirement health care costs for the government sector of the economy will affect the growth in GNP-PI because GNP-PI includes government SFAS 106-like OPEB expense... If OPEB-related expenses of the government were included in the analyses, the GNP-PI would be higher, and this would have the effect of reducing the amount of the LEC's SFAS 106 expense potentially eligible for exogenous recovery."

Response -

AT&T's contention that the exclusion of the government sector from the analysis results in an overstatement of the amount of the LECs' SFAS 106 expense eligible for exogenous treatment is completely invalid, because it is based on a misstatement of fact. The statement that "the GNP-PI includes government SFAS 106-like OPEB expense" is simply wrong. Government entities are not subject to SFAS 106, nor are they required by the Government Accounting Standards Board (GASB) to account for retiree medical benefits on anything other than a "pay-as-you-go" basis. It must be emphasized that the critical issue is not what effect will the increase in the "pay-as-you-go" costs of retiree medical plans have on GNP-PI. (The GNP-PI will increase due to increases in "pay-as-you-go" costs, regardless of whether SFAS 106 ever becomes effective.) Rather, the critical question is what effect will there be on GNP-PI, due to the requirement that private sector employers change the way in which they account for retiree medical plans. As AT&T

itself concedes, government sector employers are not required to change their accounting for retiree medical plans, and therefore the fact that many governmental entities sponsor such plans is not relevant to the analysis. As a result, the Godwins Report considered the government sector (see page 21 of the study), and correctly excluded it from the covered population for the calculation of the increase in labor costs experienced by firms subject to SFAS 106.

<u>MCI Contention</u> - (Page 26)

"The USTA study uses data from only one insurance company to arrive at the cost of medical claims for the calculation of the nationwide Benefit Level Indicator."

<u>Response</u> -

The inferred intent of the MCI comment is to suggest that Godwins used "data from only one insurance company" to come up with per capita claim costs, which were then used to derive aggregate SFAS 106 costs for the U.S. as a whole. MCI has clearly failed to appreciate the validity of the data, and the limited use to which the insurance company claims data was put. In particular,

(1) The insurance company used is, by any measure, one of the five largest Life and Health insurance carriers in the United States.

(2) The data collected was for <u>gross medical claims</u>, not amounts reimbursed by company plans.

(3) The data was sufficiently extensive to ensure that no statistical fluctuations (i.e., sampling errors) would materially affect the results.

(4) The data was used to form a frequency and amount distribution, against which actual plan provisions of the LECs and the companies in the Godwins database were applied, to evaluate the relative benefit levels of the TELCO plans compared to those provided by other employers.

(5) Changes in the underlying distributions derived from the insurance company data would not have had any significant effects on the ultimate result. This is because the key results of the Godwins study were related to the ratio of the GNP-BLI to TELCO-BLI, and not to the absolute value of either.

Ad Hoc Contention - (ETI) (Page 21)

"Finally, the Godwins Report ignores *the usual uncertainty that is associated with survey results measured by calculated standard errors*. As we discussed, Godwins utilized data from a survey of 830 employers who sponsor post-retirement plans and 170 employers who do not. It is a well accepted fact that data from surveys are subject to uncertainty which is usually measured by the standard error.[40] However, these standard errors are never taken into account in the calculation of the Benefit Level Indicators (BLIs). Thus the data shown in the table on page 28 of the Godwins Report assumes that the standard deviation is zero. This is obviously incorrect. Furthermore, there is no information as to the variance or the standard deviation of the sample data so that the sensitivity of the results can be analyzed. Combined with the fatal errors discussed above, this shows a report which was designed to come to a particular conclusion favorable to the LEC's."

Response -

The "standard error" for the calculation of the average Benefit Level Indicators was not shown[1] because in this case, the effect of the "standard error" was deemed to be

1 Ad Hoc references page 28 of the Godwins Report. We assume that they are referring to the table shown on page 16 of the report since there is no table nor any data appearing on page 28 of the Godwins Report.

immaterial. The reason it is immaterial is that the Godwins data is not a "survey" in the traditional sense of the word (i.e., a small sample from a large universe); rather, it is a data base comprising companies that employ approximately one-half of all employees who work for companies that provide post-retirement medical benefits.

However, in the interest of completeness, we have included in Appendix A the calculation of the variance and standard deviation, which are inherent in the calculation of the average BLIs used in the Report. As can be seen from the exhibits, the standard deviation for the average pre-65 BLI is .015, while the standard deviation for the post-65 BLI is a mere .008. Had the average BLIs been one standard deviation higher than the values actually used for both the pre-65 and the post-65 BLI, the relative impact of SFAS 106 on GNP compared to TELCO would have increased from 28.3% to 29.1%. Given that the sensitivity analysis of the overall result utilized a range for this value of 17.8% to 44.5%, it is quite clear that the effect of the "standard error" referred to by ETI is immaterial.

B. Actuarial Assumptions

There was one objection raised regarding the reasonableness of the assumptions utilized in determining the ratio of GNP-BLI to TELCO-BLI.

MCI Contention - (Page 28) FN 35

"Within the USTA study, in its flawed attempt to estimate relative benefit ratio levels, the consultant utilizes turnover rates that are markedly lower than the average turnover rate. This results in inflated estimates of the OPEB liability. Like most of the assumptions used by USTA, the grounds for this are unsupported. USTA remarks that it chose this estimate because of the historical patterns of longer service life and higher average age for TELCO employees versus other employees. Unfortunately, the study does not indicate what time frame was used for this comparison, or whether the experience of the last few years, with the large amount of downsizing exhibited by the TELCO firms, has been included."

Response -

There appear to be two contentions made in MCI's comment. First, that the Godwins study did not use the "average turnover rate" for TELCO and second, that even if the average rate, based on "historical patterns of longer service life and higher average age" were used, such turnover rates would still be too low because of "the large amount of downsizing exhibited by the TELCO firms."

With respect to the first contention, the turnover rates used for TELCO (T-2) are the average of the rates used by the LECs in their most recent actuarial studies (generally 1990 or 1991). With respect to the second contention, downsizing through Early Retirement programs should not have any impact on assumed turnover rates because such turnover rates are only utilized for projecting future pre-retirement withdrawals. This should be obvious since an individual is no longer subject to the turnover rates once that individual becomes eligible for retirement.

Further, MCI seems to have misinterpreted the statement made in the Godwins Report (page 48-FN 3) that,

> "Supporting evidence for low incidence of turnover at TELCO relative to national average can be seen by the higher average age and past service of TELCO employees relative to average age and service of national working population."

The point here is not that there have been "historical patterns of longer service life and higher average age for TELCO employees," but rather that the current age/service characteristics of TELCO (age = 41.6 / service = 16.6, as of 1/1/91) provide evidence of low turnover rates (i.e. low turnover rates in the past produced the current demographic makeup of the group). Recent downsizing could not have contributed to producing these age/service characteristics because recent staff reductions among the LECs were not accomplished through layoffs among the younger short-service employees prior to 1991.

While the above concept is well known among professional actuaries, we have performed some additional analysis and provided a more detailed explanation below, which should make our point somewhat clearer.

The average age and service of an employee group is not a simple function of withdrawal rates, but higher withdrawal will generally push down averages.[2]

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2 The fact that the average age of a population will increase if mortality rates are reduced is obvious. It can also be shown that a similar effect occurs in a company's "population". An employee group has exits from death, retirement, and termination, which exits correspond to mortality in the general population. Population growth, the growth of the firm, and the economic cycle all affect the number and average ages of replacements, which replacements correspond to births in the general population. Since the calculations for TELCO were based on very large employee groups, the variations in growth of firms cannot hide the effect of withdrawals.

Calculations were performed to test the hypothesis that the "T_6 / T_2" choice of withdrawal tables was consistent with the observed differentials between average age and average service of TELCO compared to the nation as a whole. With hire age and retirement age as parameters for calculating the average age and average service of stationary populations resulting from T_2, T_6, and T_{10} based upon all retirements at a given retirement age and all hires at a given hire age, the table in Appendix B clearly indicates differences that are not only consistent with the results shown in the Godwins Report, but in fact suggest that the differences in turnover rates between TELCO and the rest of the U.S. working population may be even greater than T-2 versus T-6.

For example, if one were to look at a company that hires new employees at an average age of 27, that experiences turnover rates equal to T-2, and retirements at age 62 (a situation not unlike TELCO), one would find that after this company matures it can expect to have an employee population with an average age of 41.54, and an average past service of 14.54 years. If, instead, turnover rates equal to T-6 were applied, the average age and service of the population would be 38.80 and 11.80, respectively. This theoretical difference, between populations subject to T-6 and T-2, is actually less than the observed differences in age/service characteristics between TELCO and the non-TELCO firms (see page 47 of the Godwins Report). While TELCO and the rest of the GNP have different retirement patterns, it can be seen from the table that differences in average retirement ages have only a minor impact on the basic result.

Finally, it should be noted that the sensitivity analysis performed by Godwins is more than sufficient to allow for any potential understatement of TELCO's turnover rates. On pages 34 and 35 of the Godwins Report, it is shown that even if the same turnover rates were used for both TELCO and the rest of the working population, the relative impact of SFAS 106 on GNP, compared to TELCO, would only increase from 28.3% to 34.6%. As noted on page 40 of the Godwins Report, overall results are shown using values for this relative impact, ranging from 17.8% to 44.5%.

C. **Accuracy and Reliability of Results**

There were two objections raised with respect to the overall accuracy and reliability of the Godwins findings that labor costs of non-LEC firms sponsoring retiree medical plans will increase 3.19% as a result of SFAS 106.

AT&T Contention - (pp. 9 - 10)

"The results of the Godwins Study depend on the calculation that the adoption of SFAS 106 will increase labor costs by 3% for firms incurring OPEB expenses. The 3% estimate is derived using numerous factors, each subject to error as noted in Godwins' section on sensitivity of results (pp. 34-43). The cumulative impact of reasonable variations in each factor renders the 3% estimate suspect."

Response -

It is precisely the sensitivity analysis referred to by AT&T that gives us great confidence in the robustness of the bottom line result. In the extremely unlikely event that the actual increase in labor costs is as high as 5% (extremely unlikely, because such a result would require that virtually all of the factors for which uncertainty exists[3] have been maximally understated)[4] then the total amount of unrecovered SFAS 106 costs is reduced by a mere 12% (from 84.8% to 74.7% as shown on page 41 of the Godwins study). Thus, there can be little doubt as to the solidity of the results, and the Commission can be quite confident that any uncertainty in the basic results of the actuarial analysis will not have a significant effect on the final result.

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3 See pp. 34-37 of the Godwins study.

4 In fact, great care was taken to be conservative in estimating those factors to ensure that the impact of SFAS 106 on GNP-PI was, if anything, overstated. See, for example, the following in the Godwins Report:

- Calculation of prefunding adjustment (page 19)
- Basic BLI methodology (page 34)
- Average retirement ages for non-LECs (page 35)
- Discussion of labor cost percentage adjustment (pages 36-37)

MCI Contention - (Page 25) "In no place within the study is there an attempt to verify the costs of SFAS 106 to non-LEC firms."

"The 3.19% increase in labor costs to non-LEC firms providing OPEB does not square with other estimates of the SFAS 106 costs..... This amount is only 40% of the estimates by Warshawsky (in Postretirement Health Benefit Plans: Costs and Liabilities for Private Employers, No. 76 Finance and Economics Discussion series, Division of Research and Statistics, Division of Monetary Affairs, Federal Reserve Board, Washington, D.C., June 1989)."

Response - MCI's contention is a gross misrepresentation of the facts. It is true that in the referenced article Warshawsky does estimate that, based on 1988 data, the aggregate increase in retiree medical expense due to the introduction of SFAS 106 would be much higher than the 3.19% estimated by Godwins. However, despite the fact that Warshawsky is a well trained economist and clearly undertook his research in a responsible manner, MCI has utilized the results of that research irresponsibly. Specifically, the following must be noted:

(1) Warshawsky himself now recognizes that his original estimate was unrealistically high, and he has significantly reduced this estimate in his most recent analysis.[5]

(2) Even Warshawsky's revised estimate is significantly higher than other aggregate estimates produced by the GAO[6] and EBRI[7] for the same time period. Despite this,

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5 "The Uncertain Promise of Retiree Health Benefits," the AEI Press, 1992.

6 General Accounting Office, Human Resources Division, "Employee Benefits: Companies' Retiree Health Liabilities Large, Advance Funding Costly," June 1989, GAO/HRD-89-51.

7 Employee Benefit Research Institute, "Issues and Trends in Retiree Health Insurance Benefits", Issue Brief No. 84, November 1988.

MCI selected Warshawsky's earlier estimate and chose to ignore both Warshawsky's revision and other lower estimates. These other estimates are quite consistent with the Godwins estimate, and are fully encompassed by the sensitivity analysis included in the Godwins Report.

(3) Warshawsky's revised estimate is itself too high because his assumptions regarding plan provisions, actuarial assumptions, and demographics were wrong. These erroneous assumptions are described in greater detail below.

(4) Estimates produced by Warshawsky, as well as the GAO and EBRI, are all based on 1988 plan provisions. The Godwins estimate is more accurate because it is based on 1990 plan provisions, which are more up-to-date.

Each of these points is discussed in greater detail below.

(1) Warshawsky now recognizes that his original estimate was wrong.

In the material referred to by MCI, Warshawsky estimated that aggregate SFAS 106 costs in 1988 dollars would have been $67.9 billion, while "pay-as-you-go" costs were $14.5 billion. This net increase in costs of $53.4 billion translates to approximately 6.82% of 1988 total compensation[8] for covered employees, and directly corresponds to the Godwins estimate of 3.19%.

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8 1988 Total Compensation for U.S. workers was $2921.3 billion as shown in the November, 1991 Survey of Current Business. Based on the GAO study, 26.8% of all workers are covered by plans subject to SFAS 106 (see page 21 of the Godwins Report). Therefore, according to Warshawsky, additional SFAS 106 costs are 53.4 ÷ (2921.3 X .268) = 6.82% of compensation.

Warshawsky now realizes that his earlier estimate was based on an erroneous demographic makeup of the total covered population (for example, the ratio of active employees to retirees used was 3.8 to 1, which is far lower than for the typical company[9]). In his recent book (The Uncertain Promise of Retiree Health Benefits, the AEI Press 1992), Warshawsky revises his estimate of aggregate 1988 SFAS 106 accrued liability and expense downward by 25% and 12%, respectively. In this new study, the aggregate estimate of SFAS 106 expense becomes \$58.9 billion, while "pay-as-you-go" costs are reduced to \$11.3 billion. Thus the net increase due to SFAS 106 of \$47.6 billion now translates to an increase of 6.08% of compensation. As shown in item (3) below, even this estimate is unrealistically high, due to the incorrect assumptions that Warshawsky relies on.

(2) *Warshawsky's revised estimate is significantly higher than other estimates of aggregate SFAS 106 costs.*

Both the GAO and EBRI produced estimates of SFAS 106 liabilities, based on 1988 data, that can be directly compared to that produced by Warshawsky. Warshawsky's revised estimate of \$332.1 billion is, in fact, 50% higher than the GAO estimate of \$221.0 billion, and 34% higher than EBRI's estimate of \$247.0 billion. While neither the GAO nor EBRI explicitly calculated the increase in aggregate annual expense as a result of SFAS 106, their liability estimates translate to increases of 4.05%[10] and 4.52%[11] of compensation, respectively. Both of these values are well within the range of values used in the sensitivity analysis performed by Godwins. Page 41 of the Godwins Report illustrates results assuming the aggregate increase in costs due to SFAS 106 range from 2% to 5% of total compensation of covered employees. Even at the very high value of 5% (high because this

9 See page 47 of the Godwins Report.

10 221 + 332.1 x 6.08% = 4.05

11 247 + 332.1 x 6.08% = 4.52

value, in addition to being materially higher than both the GAO and EBRI estimates, would also require that virtually all the factors outlined on pages 34-37 of the Godwins Report to have been maximally underestimated), the percentage of TELCO's SFAS 106 costs that are not recovered, through the GNP-PI increase and wage rate reduction, is only reduced from 84.8% to 74.7%.

(3) *Warshawsky's revised estimate is too high due to incorrect assumptions.*

In carefully reviewing the methodology employed by Warshawsky, it becomes quite clear why he arrives at aggregate cost estimates that are so much higher than the GAO and the EBRI estimates, as well as the Godwins estimate. Simply put, the methodology employed by Warshawsky utilizes assumptions regarding plan provisions, the demographic profile of the covered population, and actuarial assumptions to be used by companies to calculate SFAS 106 expense, that are demonstrably wrong. Specifically, in estimating the SFAS 106 accrued liability, Warshawsky:

- Assumes a "reasonably generous health plan with low deductibles and co-payments" for <u>all</u> companies (Pg. 92). A multitude of surveys (see, for example, <u>Health Care for Retired Employees</u> by Betty Malroy Stagg, The Conference Board Research Bulletin No. 202, 1987) demonstrate that this is simply not the case. Many companies in fact provide quite a bit less than "reasonably generous" benefits.[12] In fact, using data not available to Warshawsky, the Godwins BLI methodology was developed to specifically isolate the variation of "generosity" among companies' retiree medical plans.

12 See page 7 of the Conference Board report cited above and pages 9-11 of the <u>Hewitt Associates 1990 Survey of Retiree Medical Benefits</u>.

- Assumes lifetime coverage for both the retiree and his spouse, for all companies. This is clearly unrealistic, and contradicted by the Conference Board material referenced above.[13]

- Assumes all active employees become eligible for full benefits at age 55. This also is contradicted by the studies referred to above.[14]

- Assumes mortality at 83 GAM[15] rates while many companies continue to assume higher mortality rates.

- Utilizes a 1% spread between the discount rate and medical trend rate combined with a 4% per year aging factor.

- Assumes a retirement age of 62.5, in contrast with the evidence of average retirement ages between 63.5 and 64, as shown on page 35 of the Godwins Report.

Strong evidence that Warshawsky's actuarial assumptions as to trend and mortality result in unrealistically high SFAS 106 costs can be seen from the fact that the LECs used much lower cost assumptions to calculate their SFAS 106 costs. In fact, only 2 out of the 11 LECs on whom data was collected used the 83 GAM table for their SFAS 106 calculations, and the average spread between the discount rate and the ultimate trend rate for the LECs' SFAS 106 calculations is 2.57%. This is particularly compelling, given the fact that the respondents to the LECs' filings with the Commission have indicated that they believe that the assumptions used by the LECs overstate their SFAS 106 accruals.

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13 See pages 7-8 of the Conference Board report.

14 See page 9 of the Hewitt Associates study cited in footnote 12 on the previous page.

15 The 1983 GAM mortality table is the most modern (lowest death rates) currently used for pension valuations in the United States. While it was published by the Society of Actuaries in October, 1983, it still has not been universally adopted by enrolled actuaries for their pension valuations.

In addition to the problems cited above, Warshawsky also assumes that the demographic profile of the entire covered population is a "reasonably mature and stable group" which is "typical of many large companies." While Warshawsky does not disclose the specific age and service characteristics of this group, based on his statements we must assume that it is older and has longer service than the average covered group. (Note that the GAO survey[16] reports that a very significant number of retiree medical programs are sponsored by companies with less than 500 employees.) By utilizing a demographic profile of such age/service characteristics, Warshawsky is undoubtedly overstating aggregate costs still further.

(4) *All three estimates (Warshawsky, GAO and EBRI) are based on out-of-date data.*

After rejecting Warshawsky's estimate due to the serious problems noted above, there still remains the question of why the GAO and EBRI estimates are both slightly higher than the Godwins estimate of aggregate SFAS 106 costs. The simple explanation for this is that retiree medical plans have changed substantially, between the time the data was gathered for the three estimates noted above (1988), and the time period for which plan provision data was collected for the Godwins study (1990). In fact, according to the Hewitt Associates 1990 Survey of Retiree Medical Benefits, 70% of all surveyed companies changed their retiree medical plans in 1988 or 1989. Thus, the Godwins estimate must be regarded as more accurate because it uses more recent information.

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16 General Accounting Office, Employee Benefits, "Extent of Companies' Retiree Health Coverage," GAO/HRD-90-92, March 1990.

SECTION III

RESPONSE TO OBJECTIONS REGARDING MACROECONOMIC ANALYSIS

A. Methodology and Choice of Model

MCI and AT&T raise three questions about the choice of a macroeconomic model and its use in estimating the impact of SFAS 106 on GNP-PI.

MCI Contention - (Page 31)

"Such a model, in its final form, is nothing more than a somewhat advanced spreadsheet model. ... This cannot be viewed as an objective forecasting tool, but rather as a means to legitimize overly simplistic calculations."

Response -

By calling the Godwins model a "somewhat advanced spreadsheet model", MCI means that the model is used to perform "what if" exercises. But a "what if" exercise is exactly what is required to study the impact on GNP-PI of the introduction of SFAS 106. To calculate the differential impact of SFAS 106, we need to ask "what happens to the value of GNP-PI if SFAS 106 is introduced." Any economic model, even a large-scale commercial econometric forecasting model, would have to be put through a "what if" exercise to determine the impact of SFAS 106. The criticism of the Godwins model for being used to perform "what if" exercises is unwarranted.

MCI Contention - (Page 32)

"USTA contends that the model, while not being useful for forecasting macroeconomic activity, can somehow be used for forecasting the differences in macroeconomic activity depending on a shift in an exogenous variable (the multiplicative term used to adjust labor costs for the SFAS-106 impacts.)" [footnote not repeated here] This distinction is artificial--if a model cannot be relied upon to forecast the interactions within the economy, how can it be utilized to predict the differences due to some alteration to one value within the model?"